COMPETITION FOR VIDEO PROGRAMMING:

ECONOMIC EFFECTS OF EXCLUSIVE DISTRIBUTION CONTRACTS

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Executive Summary

Congress enacted 47 USC §548(c)(2)(D) in 1992, barring exclusive program sales by satellite-delivered programming services vertically integrated with cable system operators. This restriction will sunset in 2002 unless the Commission finds "that such restriction continues to be necessary to preserve and protect competition and diversity in the distribution of video programming." 47 USC §548(c)(5)

Blanket prohibitions on exclusive contracts rarely if ever make economic sense. Exclusive contracts are very common in competitive markets because they typically enhance economic efficiency without impairing competition. In the rare circumstance where such contracts can profitably foreclose efficient competitors from access to an essential resource there is already an effective remedy. Rather than resorting to a one-size-fits-all prohibition, concerns about anticompetitive behavior in a market are more efficiently addressed on a case-by-case basis, as is available under current federal antitrust law.

Accepting at face value the economic legitimacy of Congress' concern, it is clear that any danger Congress foresaw in 1992 has now receded. A vertically integrated cable operator that seeks to foreclose competitors by refusing to sell key programming sacrifices the potential profits from such sales. Foreclosure is unprofitable if these lost profits exceed the gains from whatever reduction in competition results. The lost profits from foreclosure clearly grow larger as the size of the competing program buyer increases. Thus, the fact that competing MVPDs are now very important participants in the purchase of video programming means that attempts at foreclosure are even less profitable (or even more unprofitable) than they would have been ten years ago. The potential gains from foreclosure have declined for the same reason. Vertically integrated cable operators account for only a modest part of the sales of the program production industry. Competing MVPDs are now large enough to attract independent producers and to support vertical integration into program production, meaning that cable operators could not achieve market power in distribution markets by withholding their current programming. Consequently, vertically integrated cable operators would have much to lose and nothing to gain today from attempts to withhold their programming from rival MVPDs.

Congress' concern with vertical integration was misplaced even in 1992. Anticompetitive foreclosure, if it were profitable, could occur through exclusive contracts between cable operators and independent program sources. Vertical integration is neither necessary nor sufficient to make foreclosure profitable. That cable operators have not attempted to foreclose competitors by purchasing exclusive rights to independent programming provides strong evidence that foreclosure was never profitable. Put differently, if cable MSOs had believed in 1992 or thereafter that foreclosing of competition would be profitable, they could have spun off their programming interests to independent owners and entered into exclusive contracts with them. The growth of MVPD competitors since 1992 implies that the potential losses from attempted foreclosure have steadily increased.

Exclusivity is a common and competitively desirable feature of many commercial contracts. Exclusivity is particularly common in the sale of intellectual property rights. Exclusivity is the norm rather than the exception in the sale of video program distribution rights. Exclusivity arises from a competitive market process because it can enable program producers to make their properties more valuable to distributors. This happens because exclusivity makes the incentives of distributors and programmers more compatible, reduces inefficient free riding, and permits economies of scale and specialization in each stage of program production and distribution. Exclusivity also permits MVPDs to compete more vigorously by differentiating their products. The effect of exclusivity therefore is to increase both the quantity and quality of video programming (and thus, presumably, the diversity of program content) by increasing incentives to invest in programming. It follows that a ban on exclusive program distribution contracts reduces output and program quality, injuring consumers.

Under the ban, MVPDs that compete with cable operators have less incentive to invest in new, differentiated programming because they can more cheaply offer duplicate cable programming. Thus the current ban has reduced the diversity that would otherwise attend the entry of new MVPDs. In contrast, the successful entry of cable operators in competition with over-the-air broadcasters was accomplished by substantial cable operator investment in new programming.

Similarly, the entry of the Fox broadcast network in competition with ABC, CBS and NBC was accompanied by a program strategy that emphasized both new and sharply differentiated content and successful competition for exclusive rights to such “key” programming as NFL games.

For all of the reasons described above, there is no plausible economic basis for the Commission to find that the restriction on exclusive programming contracts for cable operators “continues to be necessary to preserve and protect competition and diversity in the distribution of video programming.”

I. Exclusive Contracts and the Economic Choices

A. Exclusivity in competitive markets

Contracts in general and exclusive contracts in particular are absolutely essential to the efficient operation of a competitive market economy. If contracts cannot be written or cannot be enforced, the services involved must be supplied internally by the firm at higher cost, which will often imply that the firm is nonviable, and will in any event raise its prices, restrict its output, and narrow the diversity of choices, reducing consumer welfare.

Countries in Eastern Europe making the transition from central planning to market allocation have had serious difficulties in part because of the time required to establish the necessary legal and institutional machinery to enable enforceable contracts to be written. Many of these countries have discovered that a market economy without enforceable contracts may actually produce less output than the prior centrally-directed economy, despite the well-known deficiencies of central planning. The opposite result occurs if exclusivity provisions can be enforced. The producer who is able to enforce exclusivity provisions in contracts with outside suppliers of services (including distribution) will not have to produce the service in-house, at higher cost, or simply bear the higher cost and reduced efficiency that arises from incentive incompatibility between itself and its suppliers and distributors. The end result is to benefit consumers, who pay lower prices and enjoy more and higher-quality choices.

Exclusive contracts are extremely common in media industries. This phenomenon is not limited to the electronic media. Newspapers often obtain exclusive local rights to op-ed columns and other features such as crossword puzzles. Virtually every contract involving intellectual property distribution rights defines a geographic and temporal dimension in which the distributor has exclusive rights to the property. The effect of this is to enhance the overall economic value of each property by permitting rights holders to tailor marketing and distribution efforts to different categories of consumers. In a competitive context this improves efficiency and increases the output of intellectual property.[1] A single television program or series, for example, generally is sold on an exclusive basis to a broadcast network for a specified number of exhibitions (e.g., two) over a specified period (e.g., one year) within a specific area (e.g., the United States). Other rights to the program or series may be retained by the seller or sold in advance on similarly well-defined exclusive bases to others (syndicators, foreign distributors, cable networks, DVD distributors). As the Commission itself recognized in reinstating its rules pertaining to syndicated exclusivity of programs on imported distant signals, output and consumer welfare are enhanced by the exclusivity mechanism.[2]

Exclusivity in the distribution of media content, in sum, has the general effect of expanding output because it permits competing producers to earn higher profits from each item of creative intellectual property. Properties that are near the margin of profitability associated with competitive rates of return will not be produced if their revenues fall or their costs increase, which would be the result of restrictions on the use of exclusivity in contracting. Moreover, the investment incentives provided by exclusivity can result in the production of projects with more uncertain

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1 Intellectual property is commonly a "public good." An additional consumer of such a good adds nothing to production cost. For such goods uniform pricing is particularly inefficient because it excludes consumers willing to pay a positive price that is less than the uniform price but often well in excess of marginal cost. Exclusive property rights typically permit competition to take place through product differentiation, the marginal cost of which may not be zero in equilibrium.

2 *See In the Matter of Amendment of Parts 73 and 76 of the Commission's Rules relating to Program Exclusivity in the Cable and Broadcast Industries, Report and Order*, 3 FCC Rcd 5299, ¶¶ 49-89 (1988) (subsequent history omitted); *see also In the Matter of the Implementation of Sections 12 and 19 of the Cable Television Consumer Development of Competition and Diversity in Video Programming Distribution and Carriage,* MM Docket No. 92-265, First Report and Order, 8 FCC Rcd 3359, ¶ 63 (rel. Oct. 22, 1993) ("As a general matter, the public interest in exclusivity in the sale of entertainment programming is widely recognized.").

outcomes which otherwise would not be produced. Thus, in the media industries exclusive contracts, including exclusive distribution contracts, generally increase output as well as content diversity.[3]

It is truly anomalous that a whole category of exclusive contracts—those involving vertically integrated cable operators—are held to be unlawful *per se*. Exclusivity in every other sector of mass communications is common and presumptively lawful, including exclusivity in terrestrial and satellite broadcasting.

It is useful background to consider the reasons for the use of contracts in producing goods and services. Generally, contracts between firms accompany market transactions as distinguished from internal processes. Services and processes internal to a firm are directed by fiat.[4] Services provided by outside suppliers are directed by the specifications and economic incentives established in the contract. Sometimes production takes place in-house because it is too difficult to write contracts that make the outside supplier's economic incentives compatible with the incentives of the firm. Sometimes the opposite is true, as when managers cannot be as effectively motivated by standard conditions of employment as independent contractors. Another important reason for choosing outside provision of services is that economies of scale in particular functions (e.g., distribution) make the function much cheaper to obtain externally than to provide internally, even after accounting for the costs attributable to incentive incompatibility that cannot be eliminated through contracts. A third issue that arises in using external economic agents to supply services is asymmetric information: the firm may lack the information necessary to perform the function efficiently, suggesting the use of outside sources, but the same lack of infor-

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3 In most program choice models there is a positive relationship between the number of programs produced and the extent of content diversity. See Owen and Wildman, *Video Economics,* Harvard University Press (1992), Chapter 3.

4 The modern economic literature on this subject originated with Coase, "The Nature of the Firm." 4 *Economica*, 386-405 (1937). Contracts are sometimes used within firms, as with employment contracts. But such contracts typically have a much narrower purpose.

mation may make it difficult to monitor the agent's performance. If the problem cannot be solved through incentive-compatible contractual arrangements, the function must be brought in-house, at higher cost. In a nutshell, supply contracts permit more efficient decentralized production—they are a substitute for vertical integration.

The alignment of producer and distributor incentives is particularly important when the output of the industry is intellectual property. The production of intellectual property is characterized by large initial investments and uncertain outcomes. The intellectual property system provides for exclusive property rights in the results of the creative process through patents and copyrights. This promotes investment in innovation. The high-tech sector owes much of its growth to exclusive property rights and exclusive distribution contracts. Vertical alliances with distributors have fueled the innovative process increasing competition among innovators. Competition among distributors has increased as competing technologies have developed.

Producers of other outputs of the creative process such as motion pictures or other audiovisual works, which are protected through the copyright system, face similar incentives. Uncertainty, risk and relatively large initial investments are features common to most forms of intellectual property creation, and exclusivity as a feature of property rights and contracts plays a crucial role in enhancing efficiency. For example, independent movie producers (such as those who exhibit at the annual Sundance Festival) can finance movie production either with their own funds and bear the risk or contract with someone else for equity or debt financing. Each producer can direct the film personally, or contract with a director. She can market, promote and distribute the film directly, or contract with an established distributor. She could (in principle anyway) build theaters for exhibition or contract with established theater owners. All these economic choices turn on the costs and benefits of in-house versus outside provision of the various services that must come together to produce a film and deliver it to moviegoers.

Particular provisions of contracts need to be understood in the context of the economic problems facing producers. In the example of the independent movie producer we would not be surprised to find that the producer insisted on certain exclusivity provisions in her contracts with suppliers. If the movie script is purchased from a screenwriter, we would expect the producer to purchase the exclusive worldwide film rights to the script for a period of time. Failure to obtain exclusive rights to the script would mean that the screenwriter would remain free to sell the script to other producers, creating the risk that two or more movie versions of the same script would be released simultaneously. Obviously the producer will be willing to pay a higher price for exclusive rights than for nonexclusive rights. Generally, screenwriters can earn more money for a script by selling exclusive rights to one producer than by selling nonexclusive rights to several producers. Note that the effect of such a contract is to "foreclose" the script from competing producers, but that this "foreclosure" has procompetitive effects—it tends to increase output by increasing the probability that a marginal script will be produced.

A similar story explains exclusivity in distribution contracts. If a producer promotes and distributes the film herself, she retains ("internalizes") all the benefits of her own promotional and distribution expenditures. If she contracts with an outside distributor, that distributor will retain all the benefits of its distribution and promotion expenditures only if its contract with the producer is exclusive vis-à-vis other distributors serving the same potential audiences. If the producer contracts with multiple nonexclusive distributors, each will have incentives to "free ride" on the promotional efforts of the others. Generally, in these circumstances, producers are better off with exclusive distribution contracts. In making production and distribution of a particular film more profitable, the exclusive arrangement enhances the probability that the film will be made and distributed. Thus, again, the "foreclosure" effect of the exclusive contract is to increase output and to benefit consumers.

An independent film producer nevertheless does not require and will be unwilling to enter into contracts that are more exclusive than necessary. For example, the screenwriter may retain the book rights to his script because he may find that book publishers will outbid the film producer for these rights. While there may be interactions between the promotional efforts of book publishers and movie distributors with respect to a given property, these can often be coordinated through contract or self-interested cooperation. Despite any remaining opportunities to free ride, the book publisher may be so much more efficient than the movie distributor in selling books that the inefficiencies from free riding are more than offset by the performance improvements that result from narrower zones of exclusivity.

Exclusivity as a norm in contractual relations among the stages of production is hardly unique to motion pictures. Video production and distribution (which of course includes various motion picture "windows"), book, magazine and newspaper publishing, music production and distribution, and the production of sports entertainment are all examples of industry segments that rely heavily on exclusivity to enhance investment incentives and to increase output. In each case, however, exclusivity has limits, and these limits are defined by the economic tradeoffs among incentive-compatibility, economies of specialization, and like factors. The general point is that an exclusivity provision in a contract has an opportunity cost to the seller, and that it is only sometimes the case that buyers find the exclusivity valuable enough to buy. Simply put, not all contracts are exclusive, or as exclusive as they could be.

B. When is exclusivity harmful?

The big picture, then, is that contracts and contractual exclusivity play a crucial and beneficial role in market economies by permitting firms to contract for outside services rather than producing everything in-house, and making possible a more efficient and competitive provision of goods and services. As with other elements of a competitive market there exist circumstances in which exclusivity may serve chiefly as an anticompetitive device with harmful effects on consumers. The risk of anticompetitive behavior does not justify a *per se* ban on exclusivity because the vast majority of exclusive contracts benefit consumers. Banning a whole class of exclusive contracts is akin to banning a whole class of drivers (say, those over age 70) simply because a small number may be accident–prone. The cost to society of such a remedy would far exceed the benefits. A case-by-case approach, such as periodic testing of older drivers, would be better policy. Similarly, public policy should encourage freedom of contracting and ensure that contracts are enforceable through state action. Specific contracts that through their exclusivity or other provisions are harmful to consumers must be dealt with case by case. This process does not need to be invented anew in the present context, but can rely on analytically sound and well-established principles of existing law.

For more than 100 years the United States has had an antitrust law that declares "Every … contract … in restraint of trade…." to be a felony (Sherman Act §1). As the courts have long recognized, *every* contract restrains trade in some sense. To deal with this problem, the courts have developed a common law distinction between contracts whose nature is so likely to be pernicious (e.g., price fixing conspiracies) that they are held to be *per se* unlawful, and other contracts that may or may not be unlawful depending on their specific effects on competition. These contracts are analyzed on a case-by-case basis under the “rule of reason” to determine whether they tend to reduce output and raise prices, harming consumers. Therefore, in the absence of a *per se* ban and in the unlikely event of a harmful exclusive contract, consumers and competitors have the full protection of antitrust law. This formulation guarantees achieving the ultimate goal of consumer protection without prohibiting a broad class of procompetitive contracts.

Exclusive distribution contracts fall into the rule of reason category. The central issue in a rule of reason analysis of exclusivity is whether customers are injured by the practice. Customers benefit from the operation of competitive markets in which the objective of every seller is to “harm” competitors by increasing market share and output through competitive advantage. Also, of course, the elimination of competitors by means that do not benefit consumers can reduce consumer welfare. Thus, harm to competitors results both from pro-competitive as well as from anti-competitive activity. For this reason, the courts have long rejected harm to competitors as evidence of unlawful harm to competition.

For the very reasons that led the courts to decide that exclusive distribution contracts should fall under the rule of reason, it is not possible to describe in simple terms the circumstances in which exclusive contracts harm consumers. Every case is different. Nevertheless, some factors that make exclusivity more or less likely to harm consumers can be illustrated by example. The key issues are market definition and market power.

A clearer picture may emerge from an example out of the immediate context. A franchiser, such as a fast food firm, may insist that its independently-owned outlets (franchisees) deal exclusively in the franchiser’s own goods and services. Competitors of the franchiser may complain that they are injured by the exclusion of their products from the franchised outlets. Similarly, retailers who compete with franchisees may complain that they are injured by not having access to the products of the franchiser. Such complaints can be analyzed by considering what alternatives are available to each party. Formally, this is called market definition. Do customers of the franchiser have available substitutes for the franchiser’s products? Are there other fast food franchises? Could the original franchiser profitably raise its franchise fee or product prices above competitive levels? What are the barriers to entry into the franchising business? If franchise fees were raised above competitive levels and franchisees were unable to substitute alternative franchising services, would the resulting increase in consumer prices be sustainable? Or would consumers switch in such numbers to alternative sources of fast food that the franchiser would be forced to roll back its prices? These and related questions are the meat and potatoes of economic analysis of the competitive effects of exclusivity.

Case-by-case analysis is necessary in order to determine whether the parties to an exclusive distribution contract have the incentive and ability to engage in exclusivity chiefly in order to foreclose competitors. The "incentive" issue requires a comparison between the profits given up by refusing to sell to competitors with the profits gained by eliminating competitors or raising their costs. The "ability" issue requires an analysis of the alternatives available to competitors in the event that exclusive products are denied them.

A distributor that buys exclusive rights to a product solely in order to foreclose competitors must compensate the seller for the loss of revenues from other potential buyers. The greater the number and size of such buyers, the greater the required compensation. Even assuming that it is worthwhile to pay for exclusivity when the number and size of alternative buyers is small, the profitability of exclusivity obviously will decline as the alternatives available to the producer grow more profitable.

This implies, in the present context, that foreclosure would be much less likely today, given the substantial size of cable's competitors, than in the past. DirecTV is now the third largest MVPD distributor and EchoStar is the seventh.[5] As demonstrated below, satellite broadcasters now spend more than a third as much on programming as all cable operators combined. The same changes that have made foreclosure much more expensive today than in the past have made it less profitable. Cable operators could not, even if they held exclusive rights to all their most

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5 *Annual Assessment of the Status of Competition in the Market for the Delivery of Video Programming*, Seventh Annual Report, 16 FCC Rcd 6005, ¶¶ 62-63 (2001)

popular programming, prevent competitors from contracting for other popular programming. Cable operators, even collectively, simply do not account for a sufficiently large share of sales of video program rights. In 2000, as shown below, cable operators accounted for only about 22 percent of all U.S. expenditures on video programming. These facts also belie the *ability* of cable operators to foreclose access to the market. Competing MVPDs can buy or make their own programming, just as cable operators themselves bought and made original programming in order to compete successfully with broadcasters, and just as new broadcast networks have bought or made original programming (and even outbid larger networks for the most popular programming) in their successful bids to enter the market.

II. There is No Justification for Subjecting Vertically-Integrated Programmers and Cable Operators to Special Restrictions on Exclusivity

This proceeding involves the current requirement that video programming sold by firms in which cable operators have an ownership interest must be sold non-exclusively (if delivered by satellite). It is difficult to imagine a policy argument for preservation of this requirement that does not rest at least implicitly on two premises: (1) Absent the ban, vertically-integrated cable operators have the incentive and ability to harm competing MVPDs through exclusive deals and (2) Regardless of the procompetitive effects of exclusive contracts, competitors to cable operators need the ban in order to be able to continue offering successful competitive programming packages.

As for the first premise, for the reasons set out in Section I, there can be no validity to any general assumption that exclusivity, including exclusivity in the sale of vertically-integrated programming to cable operators, is motivated by or will result in the creation or retention of market power or harm to consumers. Indeed, the odds overwhelmingly favor the opposite assumption because exclusivity is the norm rather than the exception in video distribution contracts that arise in contexts where anticompetitive foreclosure could not possibly be a concern. Furthermore, it follows from the discussion in the previous section that the reliance on any assumption is unwise and unnecessary in light of the availability and direct applicability of antitrust principles honed by more than a century of prosecutorial and judicial experience.

The second premise assumes that MVPDs competing with cable operators cannot enter and grow without access to programming produced by vertically integrated cable networks. As explained below, there is no basis for this assumption either in historical experience with such entry or in an objective analysis of concentration in the production of programming.

1. What are the economic incentives of programmers and cable operators?

Every program producer creates intellectual property for sale in a risky environment. It is extremely difficult to predict which products will be sufficiently attractive to audiences to justify the expenditure required to create them. Exacerbating this business problem for program producers is the fact that their products are public goods. Most production and promotion costs must be incurred upfront. It is therefore extremely important to reach the largest possible potential audience.

Program producers face competition from others with access to the same input markets. "Hollywood" markets (not, of course, limited literally to the Hollywood, California area) supply writers, actors, directors, distributors, capital, and the host of technical skills required to produce video products. Program producers typically organize project-specific teams of these inputs for each program venture. While some inputs are specialized and every actor or other talent may be better at one medium or genre than another, there is broad fungibility in the uses of many inputs. Actors, for example, can and do shift from film to video to stage and back again, and most of the "below-the-line" (non-talent) inputs are also fungible. Similar statements apply to many of the inputs used in the production of programming such as sports, news, and public affairs.

Generally, the use of more expensive inputs increases the chances that a program will be successful. Star talent or directors with a good track record will command higher fees because they can increase the odds that the production will be successful, but of course their higher fees also increase the cost of the program. The same is true of star players on sports teams. Similarly, inputs that add production values (e.g., on location shooting, special effects) tend to increase the chance of success while increasing cost. Of course, nothing guarantees success. There are many strategic paths through these tradeoffs. Many producers choose low-budget productions whose chances of major success are modest, but whose failure will be relatively inconsequential.

Similarly, success may be more likely with tried and true formulas and talent, but different, more diverse and riskier productions may present a better risk profile given their lower costs.

Program distributors such as MVPDs and broadcast networks have access to a variety of programming sources. Success depends on offering a menu of programs and a price attractive to consumers in comparison to competing distributors' offerings and on attracting audiences that are attractive in size and composition to advertisers.

Against this background, why would a program producer enter into an exclusive contract with a particular distributor? The reasons given in Section I above supply the most obvious answers. Suppose a given potential audience can be reached by two or more distributors (media) at the same time. The producer of program A may rationally fear that non-exclusive sales will reduce the incentives of each distributor to promote program A, as opposed to other programs. This fear may arise partly because each distributor will be unable to capture for itself all the benefits of its promotional expenditure and partly because each distributor can "free ride" on the efforts of its competitors. Further, the producer of program A will frequently find that each distribution medium is willing to pay a premium for exclusivity in order to attract subscribers who are particularly interested in that program. In the absence of program exclusivity, each medium will be able to distinguish itself from its competitors only in quality dimensions that are less competitively effective than program content. If price is the only significant dimension in which competition can take place, the industry may collapse to a single distribution technology or even a "natural" monopoly. Nonexclusive sales are most likely to be profitable to program producers when there is relatively little overlap between the potential audiences served by two or more distribution channels, and distributors will share this perspective. Nonexclusive sales are also more likely in cases where the producer rather than the distributor is responsible for promotion, and where no one distributor is capable of making the product conveniently available to consumers.

The profitability of exclusive contracts in the distribution of a particular program in the right circumstances has great significance for consumer welfare and program diversity. First, greater profits will attract new distributors resulting in the delivery of more diverse programming at lower prices. Second, increased profitability, given the competitive structure and low barriers to entry in program production, implies that the number and quality of programs will increase. A ban on exclusivity obviously has the opposite effect: such a ban tends to reduce output and diversity. Failure to permit the current rule to expire, especially if it is no longer (or never was) required to facilitate entry, is therefore likely to result in reduced program investment, reduced programming output and reduced diversity, compared to a world without such a constraint on market transactions.

2. What does vertical integration add to this picture of the program producer's economic choices?

A place to start is with the reason for the existence of vertical integration. Why are some program producers partly or wholly owned by distributors? Why do some distributors own interests in some of their program suppliers? The answers to these questions again lie in the economics of competition in program production and distribution. For example, a new distributor may find the supply of programming inadequate for its special needs or too expensive, and may therefore simply produce some or all of its own content, or supply equity capital to program producers to increase supply. A new program producer may seek an assured outlet for its programming and may be willing to offer equity in return. A distributor, seeing that its program costs are elevated by the riskiness of the programming business, may seek to lower its costs by providing equity capital at rates below the rates available to programmers from other sources. A program producer may seek to gain first-hand knowledge and experience of the business of distribution so as to enhance the effectiveness of its own production decisions. And so on.

It is perfectly clear, for example, that early investments by cable operators in programming such as HBO, CNN, BET and C-SPAN were intended to increase the supply of attractive programming in order to permit cable systems to compete with broadcasters by bringing new and more attractive programming to viewers.[6] This was crucial in urban areas where cable carriage of local and distant broadcast signals added little value to the relatively large number of over-the-air choices available. Whether or not such programming would have become available eventually in

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[6] In the case of CNN and the other Turner cable interests, cable MSOs contributed equity capital to rescue programming that was at risk of financial failure.

the absence of cable operator investment, it certainly happened faster with cable operator assistance. The risks faced by such program sources included risks under the control of cable operators. Vertical integration internalized those risks and lowered the cost of production, increasing its supply.

The existence of vertical integration can therefore be explained by procompetitive motivations; there is no need to assume that vertical integration was motivated by anticompetitive intentions. Vertical integration is not evidence of an intent to foreclose competition.

The next step in the analysis is to ask whether a vertically-integrated distributor (whatever the reason for the vertical integration may have been) has a different incentive or ability to foreclose competition than a non-integrated distributor (as the Commission asserts in ¶6 of its Notice). It might be argued that the anti-competitive potential may be more acute when in addition to an exclusive contract there exists vertical integration between cable operators and programming producers. However it turns out that there is no theoretical or empirical support for this argument. Vertical integration is neither necessary nor sufficient to achieve exclusivity.

Any program producer that is vertically integrated with a distributor will rationally balance the costs and benefits of exclusivity (including effects on competing firms) in much the same way as a producer that is not integrated. If a distributor values an exclusive contract for a particular program so highly that it is willing to pay more than the opportunity cost of the producer that arises from not selling to other distributors, then an exclusive contract will be negotiated. Even if part of the benefit to the distributor from denying the program to competing distributors can be characterized as anticompetitive, a contract can achieve the same effect as vertical integration.

Vertical integration could be required as a necessary means of foreclosing programming to competitors only if exclusivity costs the programmer more than the miscreant distributor is willing to pay in a market transaction, so that the programmer must be *ordered* to engage in foreclosure against its own interest. But in that case, of course, vertical integration simply assures that the programmer's lost profits attributable to uneconomic or anticompetitive exclusivity fall entirely on the programmer's owner, the distributor. It makes no sense to imagine that the distributor can profitably gain through vertical integration what it cannot profitably pay for in an arms length transaction with program suppliers. Otherwise, a man could pick himself up by his bootstraps. This reasoning has two implications:

Implication 1: The ban on exclusivity by vertically integrated programmers has always been useless in preventing anticompetitive foreclosures. If anticompetitive foreclosure were a serious threat, an effective ban would need to prohibit exclusivity in the sales of *all* program rights to MVPDs, no matter who owned those rights. For example, the major professional sports leagues would have to be prohibited from engaging in exclusive distribution deals. Indeed, the fact that MVPD competition has grown rapidly over the ten-year life of the current ban despite the fact that the ban applies to only about half of the subscriber-weighted programming sold to MVPDs demonstrates the lack of need for such a ban.[7] Put differently, if cable MSOs had thought that foreclosing of MVPDs would be profitable they need only have spun off their programming interests to independent owners and entered into exclusive contracts with them back in 1992. The current ban therefore can have no benefits, only the costs associated with an artificial constraint on efficiency-enhancing transactions.

Implication 2: Vertical integration by cable operators must have some explanation other than attempts to foreclose competition. The most obvious explanations are based on cost savings. Cost savings lead to consumer benefits in the form of lower prices, expanded output and higher program quality.

The efficiency effects of vertical integration actually reduce any harm from foreclosure attributable to exclusivity. Vertical integration by cable operators offers several potential social benefits in addition to those described above in explaining why vertical integration might lower program production costs. First, assume hypothetically that cable operators are monopolists of a prop-

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7 MSOs have ownership interests in 6 out of the top 15 cable networks using subscriber weighting, and an MSO has ownership above 50% in only three of these. *Annual Assessment of the Status of Competition in the Market for the Delivery of Video Programming*, Seventh Annual Report, 16 FCC Rcd 6005, Appendix D, Table D-7 (2001).

erly-defined relevant market within their respective franchise areas.[8] In that case, it is likely that they are also monopsonists of video programming in their territories.[9] Monopsonists facing an upward-sloping supply curve tend to buy too little at too low a price, restricting output in programming markets. Vertical integration would eliminate this inefficiency, expanding the supply of programming available to subscribers. Second, vertical integration may avoid transaction costs as discussed in Section I. A recent empirical study by Chipty claims that the net impact of vertical integration between programming and distribution may be to improve consumer welfare for this reason.[10] Thus, even if cable operators are assumed to have market power and even if exclusive program contracts are assumed to foreclose competition, vertical integration should be regarded as an ameliorating factor, not one that exacerbates the problem as suggested in ¶6 of the Commission's Notice.

3. Is it possible to make economic sense of the current ban?

Even if the preceding points are set aside, the current ban goes further than necessary and therefore creates unnecessary inefficiency. Suppose, contrary to the arguments made above, that vertical integration permitted cable operators to achieve something that exclusive contracts did

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8 The Commission's annual MVPD reports imply that monopoly is not a factual characterization; MVPD competition is growing. *Annual Assessment of the Status of Competition in the Market for the Delivery of Video Programming*, Seventh Annual Report, 16 FCC Rcd 6005, ¶¶ 6-8 (2001).

9 Because programming is a public good, purchasers in one territory do not compete with purchasers in another territory. Cable operators in their territories compete with other MVPDs serving the same areas, as well as other media. DBS is technically capable of providing local programming and of local pricing, and although its service areas currently are broader than those of most cable systems, this is likely to change with the next generation of satellites.

10 Chipty, "Vertical Integration, Market Foreclosure, and Consumer Welfare in The Cable Television Industry." 91 *American Economic Review* 428-453 (2001).

not—to exclude or raise the costs of competitors. Even in that case, the incentive of cable operators to engage in foreclosure could not reasonably be thought to extend beyond the geographic areas in which they provide cable service. Outside those areas, there could not possibly be a profit motive for foreclosure of anyone at the expense of profits from the sale of programming. Of course, one can imagine an elaborate conspiracy that might produce such a result, but the conspiracy would face insurmountable problems because the costs and benefits of foreclosure would not fall symmetrically on the participants, requiring unenforceable promises to make ongoing secret (because unlawful) side payments.

Furthermore, a majority of vertically integrated cable operators own only partial interests, and often non-controlling interests, in programmers.[11] In those cases, even within the geographic areas served by cable operators with vertical interests, foreclosure through unprofitable denial of programming to competing distributors would be difficult because the remaining owners of the programmer would have to sacrifice profits to benefit the cable operator, and that fact would be evident given the differential policies of the programmer inside and outside the territories served by the cable operator. A controlling third-party stockholder simply would not permit this, and minority or non-controlling owners would either seek *ex post* redress or demand *ex ante* compensation for this risk.

4. What does it take to foreclose competitors?

Profitable foreclosure, as indicated above, requires that the benefits of foreclosure (in higher downstream prices) exceed the costs (in lost upstream revenues), a condition likely to be met, if ever, only in the territory served by the foreclosing distributor. That is, a cable operator hoping to exclude a rival MVPD in a specific franchise area through foreclosure would want to compare the extra cost of obtaining exclusive program rights in that territory to the extra revenue it might

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[11] Of the 99 networks with MSO ownership interests, 38 had MSOs interests of 50% or less. *Annual Assessment of the Status of Competition in the Market for the Delivery of Video Programming*, Seventh Annual Report, 16 FCC Rcd 6005, Appendix D, Table D-1 (2001).

get if competitors are excluded as a result. It would make no sense to buy exclusive rights outside the franchise area. Foreclosure of competitors also requires control of a resource that competitors need in order to offer products and prices enticing to the distributor's customers. It does no good for a cable operator to deny a program to a rival MVPD if the rival MVPD can readily obtain substitute programming elsewhere, through purchase or through its own vertical integration.

Foreclosure of access to programming on a scale sufficient to exclude competitors or significantly raise their costs would require a cable operator to control (through exclusive contracts or vertical integration) a large portion of all available programming. Alternatively the integrated firm might attempt to harm competitors by denying access to the most valuable programming. To maintain such foreclosure over time would require the cable operator to control the inputs used in the production of programming. Otherwise new programmers would enter or rivals would integrate vertically to produce their own programming, bidding away inputs. Further, competitors, using access to similar inputs, can identify the characteristics of the most valuable programming and create their own competing programs. For example, a vertically-integrated premium movie channel cannot be used to exclude competitors if studios are free to sell cable distribution rights to other distributors upon the expiration of current contracts.

Even if a studio granted it exclusive distribution rights to a particular successful movie, it is unrealistic to think a cable operator could prevent rival distributors from acquiring the rights to deliver other successful productions. The relevant market for programming in this context includes all programming to which rivals could and would turn if a hypothetical cable operator controlled the supply and raised the price of some or all of its current programming. For a cable operator to have market power in that relevant market, it must not only control a large share of the business of cable program distribution but also be able to prevent entry into "programming" itself. Sustaining higher prices in distribution over time requires preventing the entry of new firms attracted by higher profit margins. Higher margins can be a response to foreclosure. Additional competition will put downward pressure on prices and increase the opportunity cost of foreclosure. The absence of barriers to entry in program production makes profitable foreclosure an unlikely outcome.

Given the tradeoffs described above in the programming choices of distributors and the fungibility of program production inputs, cable operators' shares of the relevant market are far too low to permit successful foreclosure of rivals. In purchasing programming (and, ultimately, program inputs) cable operators compete not only with other MVPDs as defined in the Commission's annual reports on MVPD competition, but also with other program distributors such as broadcast stations and networks and cinema channels. On the margin much of this competition takes place in terms of the timing of exhibition windows.[12] If the cable distribution window for films or sports broadcasts becomes less profitable due to reduced competition, programmers will adjust the timing or the extent of the cable window, expanding adjacent windows.

The appendix to this paper contains a rough estimate of the program expenditures of various video distributors for the year 2000, net of distribution fees. The analysis is summarized in Table 1. Total expenditures on video programming amounted to about $30.6 billion. Cable operators' expenditures on programming in 2000 are estimated to have been $6.8 billion, which is about 22 percent of overall programming expenditure. Only a fraction of the programming expenditure of cable operators, of course, is for vertically integrated programming affected by the rule. Even if *all* cable operators, vertically integrated or not, entered into an industry-wide conspiracy, profitable or not, to lock up *all* programming they currently purchase, they could foreclose only about 22 percent of the market. This meets no one's definition of a share sufficient to permit an inference of market power.

No less important, other MVPDs, chiefly satellite broadcasters, already account for nine percent of video program expenditures, or more than a third of the program expenditures of the entire cable industry. Clearly, DTH today is simply too attractive a market and has too many alternatives for program suppliers to profitably ignore.

12 Owen and Wildman, *Video Economics,* Harvard University Press (1992), chapter 2.

Table 1. Estimated 2000 Expenditures on Video Programming, Net of Distribution Fees

	Expenditures ($ billions)	Share of total (percent)
Broadcast Networks	11.1	36
Broadcast Stations (syndication)	3.9	13
Cable Operators	6.8	22
Home Video	6.0	20
Other MVPDs (chiefly satellite broadcasters)	2.8	9
Total	**30.6**	**100**

Source: See Appendix. Subject to rounding error.

As the foregoing structural analysis suggests, cable today simply does not have the economic clout, even if it were monolithic, to engage in profitable foreclosure of its programming to competing media. Even if that were not true, DTH and other MVPDs could and would vertically integrate if necessary to acquire program rights, just as cable operators themselves did in the early years of cable development. An attempt by cable operators to exclude competing MVPDs or to raise their costs through exclusive contracts would simply create profitable new opportunities for both MVPDs and program suppliers. DirecTV, EchoStar (and possibly RCN given its backing from utilities) surely have sufficient access to capital to make their own programming investments, and even if they did not their vertical integration could be facilitated by merger transactions with Hollywood or other programming interests.

5. Analysis of the current ban and other remedies for foreclosure

Cable operators today must compete not only with over-the-air broadcasters whose signals they are required to carry at the option of each broadcaster, but also with a variety of new multichannel program distributors (MVPDs), most prominently direct-to-home (DTH) satellite broadcasters such as DirecTV and EchoStar. This competition takes place not only in terms of prices but also quality of service. The most important dimension of quality of service is programming. Denying cable operators (or any MVPD) the opportunity to differentiate their products by acquiring exclusive rights to distinctive programming shifts the focus of competition to non-program dimensions that may be of less benefit to consumers. Of course, despite the current ban cable operators can acquire exclusive rights to programming in which no cable operator has an "attributable interest" or to programming that is not satellite-distributed. But this simply imposes an artificial constraint on the marketplace that necessarily raises costs, as the Commission long ago recognized in its common carrier regulation. (It was the existence of such incentive distortions that formed the basis for the Commission's abandonment of rate of return regulation in favor of rate caps in common carrier regulation.) Interestingly, it has been the DTH suppliers more than the cable operators who have obtained exclusive program rights in an effort to differentiate and promote their services. DirecTV has exclusive rights to a number of sports packages,[13] and EchoStar has rights to specialized ethnic programming. A number of new, non-vertically-integrated cable networks have appeared since 1992. So far at least, few have found it profitable to enter exclusive distribution contracts with cable operators vis-à-vis DTH.

There are in principle circumstances in which the grant of exclusivity to one MVPD in a market may wind up, deliberately or accidentally, conferring market power on that MVPD (i.e., exclusivity may raise the excluding MVPD's rivals' costs and give the excluding party power over price.) As explained above, the incentive of a cable operator to take into account any anticompetitive foreclosing effects of its decision to obtain exclusive rights to vertically-owned programming within its franchise territory depends on a variety of factors specific to its market, the nature and extent of its program ownership interests and the alternatives available to the specific competitors it faces. Case-by-case antitrust remedies are far more appropriate in dealing with such issues than a blanket *per se* rule affecting all cable operators. Antitrust remedies include not only prosecutions by the Department of Justice and the Federal Trade Commission but also actions by State Attorneys General and private treble damage actions.

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13 Umstead, "Games Still the Thing for DirecTV," 22 *Multichannel News* 86 (2001). In-Demand, a pay-per-view distributor serving cable operators with two-way PPV capability, often shares these sports rights.

III. Exclusivity Provides Consumer Benefits.

Cable operators discovered the need to increase and diversify their programming options in order to attract subscribers when cable television first began to grow outside rural environments. They did this at first through importation of distant broadcast stations into areas served by relatively few over-the-air broadcasters, despite broadcasters' and the Commission's own efforts to limit such behavior.[14] Later, cable operators sought to offer entirely new programming in order to attract urban subscribers. Again, broadcasters and the Commission sought to slow this process. At one point, for example, the Commission banned cable operators from offering movies or series episodes on premium channels![15] Nevertheless, by the early 1980s cable operators, through their own investments and through the efforts of independent programmers, had created a substantial new range of program offerings that served to provide urban viewers with an attractive alternative to their previous entertainment options. The resulting competition for viewers and advertisers transformed the video entertainment industry and eventually destroyed the hegemony of the original three broadcast networks. It also created substantial increases in output and consumer welfare benefits.

One of the means by which the audience shares of the original three broadcast networks was reduced was through the entry of several new broadcast networks, of which Fox was the first. Several characteristics of Fox's successful entry are particularly relevant to the present discussion. First, Fox succeeded in spite of the fact that it was required to compete with existing networks whose extremely popular programs were in every case protected by exclusive network broadcast rights. Second, Fox was able to outbid the original three networks for exclusive network broadcast rights to certain "key" programming, notably the NFL games that CBS had

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14 For a brief discussion of the development of the cable industry from a regulatory and economic perspective, see Owen, *The Internet Challenge to Television,* Harvard University Press (1999), chapter 7.

15 The Commission's so-called "anti-siphoning" rules were struck down in *Home Box Office, Inc. v. FCC*, 567 F.2d 9, 13 (D.C. Cir. 1977).

broadcast for many years. Third, Fox invested in a great deal of its own programming, much of it unique and innovative by previous broadcast network standards. It is noteworthy that it did not occur to the Commission to facilitate Fox's entry by requiring ABC, CBS and NBC to share with the new entrant all those networks' own program production.

Other broadcast networks such as WB, UPN, Paxson, and Univision, have launched in the past decade without the benefit of access to incumbent exclusive (or even vertically integrated) programming. Like Fox, each of these networks developed its own portfolio of programming and then protected the distribution of that programming through exclusive contractual arrangements. Not all broadcast networks have been financially successful. As with all businesses, many factors influence the success and failure of broadcast networks, but guaranteed access to a competitor's exclusive programming is never cited as one of these factors.

Similarly, what is most interesting about the history of the development of cable television is that once it began to expand beyond its initial function of improved reception in rural areas, the industry found it necessary to offer a unique set of program options. It could not survive simply by duplicating over-the-air options already available to viewers. Like early cable pioneers, DTH has come through a period in which a primary source of demand has come from subscribers interested in improved reception of existing services. Now DTH, cable operators and other MVPDs must begin to offer differentiated products in order to compete successfully for the remaining television households. But the current rule discourages this. The rule discourages cable operators from investing in new programming by forcing cable operators to bear the risk and expense of new investments while permitting MVPD competitors to capture a portion of the benefits. As to MVPDs, the practical effect of the current rule is to make it cheaper on the margin for DTH operators to duplicate existing program options than to develop new ones. Clearly, this acts to discourage an expansion of program supply and diversity. Ending the ban, to the extent that would lead to increased use of exclusivity and therefore product differentiation in MVPD programming, would therefore *increase* beneficial competition in the supply of programming to viewers, providing greater choice. Just as exclusivity enhances competition and choice in broadcasting, so it would among MVPDs, and just as exclusivity rarely if every causes anticompetitive harms among broadcasters (who, at a local level, often compete in relatively concentrated markets), so too would such adverse outcomes be unlikely among MVPDs. Anticompetitive outcomes are in any event best dealt with through the normal antitrust procedures.

IV. Conclusion

A rule restricting freedom to contract by program sources owned by cable operators never was either necessary or sufficient to create a protected environment for new MVPD entrants such as DirecTV. Exclusivity rather than vertical integration is the key to successful foreclosure. Had it been profitable for cable operators to attempt foreclosure they could have done so through exclusive contracts with independent program sources and by spinning off their own program interests to escape the bite of the rule. This has not happened, providing strong evidence that anticompetitive foreclosure was not and is not a profitable or feasible strategy. Further, MVPD competition has flourished, ending even the misguided rationale for the original rule.

The rule does however have unfortunate unintended effects on economic incentives. By permitting competing distributors to free ride on each other's promotional efforts it reduces the investment incentives of programmers subject to the rule. Moreover, the rule reduces the incentives of all MVPDs to engage in investments that will lead to differentiated products, and thus reduces both program output and program diversity.

Exclusivity is a common and central element of program distribution contracts in the mass media generally and in broadcasting. Exclusivity enhances the efficiency of transactions, aligns incentives, reduces costs, and increases the supply of programming. A rule banning exclusivity in a whole class of video distribution contracts makes no economic sense. In the unusual circumstance that a particular exclusive relationship threatens anticompetitive results, there exists a set of antitrust tools and resources designed specifically to analyze and remedy the problem.

For all of the reasons described above, there is no plausible economic basis for the Commission to find that the restriction on exclusive programming contracts for cable operators "continues to be necessary to preserve and protect competition and diversity in the distribution of video programming."

Appendix: Concentration of national video programming purchases

The purpose of this appendix is to estimate concentration among purchasers of video program rights in the United States. This appendix also explains how the data were prepared, including sources, assumptions and methods of estimation. There appears to be no comprehensive source of data on sales of video programming by producers. Accordingly, we have relied on data and assumptions from various sources. There may be comparability and other issues with these data. Therefore, these estimates should be regarded as approximations. Nevertheless, they provide a sufficient basis for the conclusions stated in the text.

The starting point is data on the 2000 expenditures by U.S. distributors of broadcast and cable television video programming, broken down by category of media outlet. All video programming has been considered, including broadcast and cable entertainment programming, broadcast and cable rights to theatrical films, news, sports and other non-entertainment programming. Additionally, the home video distribution window of theatrical motion pictures is included, but cinema rentals are excluded. Appendix Table A presents a breakdown of these expenditures. (All data in this report are subject to rounding error.)

Appendix Table A. Expenditures on Video Programming

	Expenditures ($ billions)
Broadcast Networks	11.1
Broadcast Stations (syndication)	4.9
Cable Operators	6.8
Home Video	10.9
Other MVPDs (chiefly satellite broadcasters)	2.1
Total	**35.6**

Data for ABC, CBS, NBC and Fox 2000 program expenditures are from Paul Kagan Associates *Broadcast Network Economics 2001*. This source provides the big four networks expenses on programming. For the other two smaller networks, WB and UPN, program expenses were obtained from Paul Kagan Associates, *Economics of Prime Time Television 2001*. For these smaller networks programming expense data are for the period between September 1999 and May 2000. This excludes the summer quarter, during which programming expenses are the smallest.

The 2000 expenditures of basic cable networks on programs totaled $6,402 million, according to *Kagan's Economics of Basic Cable Networks 2001*. Pay cable networks' total revenues amounted to $3,700 million in 2000. We assume programming costs were 50 percent of revenues. Pay-cable data for year 2000 were obtained from *The Pay TV Newsletter,* March 31, 2001. So-called "cable networks" sell both to cable systems and to other MVPDs. We therefore allocate to cable operators an estimate of that portion of program expenditures they actually make, while allocating the rest to other MVPDs, chiefly satellite broadcasters. The basis of allocation is number of subscribers. (The economic rationale for allocating some of the program expenditures of cable networks to non-cable MVPDs is that if vertically integrated cable networks attempted to withhold cable network programming, the competing MVPDs would be free to switch their former expenditures on cable networks to other program sources not controlled by cable operators as well as in-house production.)

In the year 2000, basic cable operators had a total of 67.7 million subscribers and pay cable had 35.8 million subscribers according to the FCC's *Seventh Annual Report on the Status of Competition in the Market for the Delivery of Video Programming*. In year 2000, according to the same report, Direct (to home) Satellite Broadcast Services (DBS) had a total of 13 million subscribers, and other competing technologies 3.7 million subscribers. Assuming the same percentage of premium-to-basic subscribers applies to satellite, the subscriber-based allocation yields a total of $363 million paid by MVPDs other than cable and DTH to deliver cable network programming.

In addition to acquiring programming from cable networks, satellite broadcasters also acquire programming directly from program producers, particularly sports leagues and movie studios. Morgan Stanley (investment reports numbers 8231987 and 29224015) reports average monthly program expenses per subscriber of $18 for EchoStar (first quarter 2000) and $19 for DirecTV (1999). Based on these program expenses and the number of subscribers we estimate DBS programming expenses to total $2,948 million (including distribution fees) during year 2000. We assume that distribution fees charged by cable networks range between 15 and 25 percent in 2000. Based on this range, payments to cable networks by satellite broadcasters, including distribution fees, are estimated to be between $1,841 and $2,086 million. The results presented in the paper are based on the most conservative assumption according to which fees were 25 percent.

Therefore we estimate that DBS paid directly $878 million to other sources of programming. Hence, the estimated total programming expenditures by satellite broadcasters are $2,442.

The syndication expenditure figure presented in table A includes both barter and cash syndication. Cash syndication amounted to $2,547 million and barter syndication $2,391 million. Syndication data were obtained from *TV Program Investor*, January 19, 2001.

Home video retailers had total 2000 revenues of $19,700 million, according to the *Hollywood Reporter*, v. 466, n. 20, January 2001. Their product expenses were estimated to be 55% of these revenues. This estimate is based on historical data on the financial ratio between revenues and programming costs, yielding a total of $10,900 million in home video distributor wholesale revenues.

Sales by downstream distributors (or purchases by downstream exhibiters such as TV stations and cable systems) are not directly comparable to expenditures on programming by distributors or others who deal directly with program sources. This is because distributors add value to the programming they purchase and deliver to exhibiters. We call this value added a “distribution fee” and subtract it from exhibitor expenditure to arrive at estimates of program sales and (equivalently) purchases.

Appendix Table B reports expenditures on programming after subtracting estimated value added in distribution, where appropriate. In the case of expenditures by broadcast networks, DBS, basic cable networks and pay cable networks, it is assumed that none went to distribution fees. Distribution fees were assumed to absorb 40 percent of U.S. distributor revenues in the case of domestic syndication (excluding barter syndication) and 45 percent in the case of home video.

Appendix Table B. Expenditures on Video Programming Net of Distribution Fees

	Expenditures ($ billions)	Net Expenditures ($ billions)	Share of total (percent)
Broadcast Networks	11.1	11.1	36
Broadcast Stations (Syndication)	4.9	3.9	13
Cable Operators	6.8	6.8	22
Home Video	10.9	6.0	20
Other MVPDs (chiefly satellite broadcasters)	2.8	2.8	9
Total	**35.6**	**30.6**	**100**

Source: See text.

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